



MICHAEL J. MURPHY
State Treasurer

Second Quarter 2005

The QUARTERLY

Local Government Investment Pool

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A flatter yield curve: What will the Fed do?

The Federal Open Market Committee (FOMC), as expected, raised its target for the federal funds rate by 25 basis points to 3.25 percent at the June 29-30 meeting. The committee also kept its language fairly intact from its May 3 release. The only notable exception was its reiterations about energy prices increasing further and inflation remaining elevated.

The text seems to suggest that further rate hikes will still follow the path of a “measured pace” and will only shift course if there are changes in economic outlook that could jeopardize the Fed’s ability to maintain its twin objectives of sustainable growth and price stability.

The market is still caught between two opposing views. On the one hand, there are investors who resolutely believe the U.S. economy will remain strong. They take comfort in labor market reports showing steady job growth and falling unemployment numbers. June payrolls increased by 146,000, which was less than consensus, but this number was accompanied by upward revisions for April and May numbers. The less-than-expected job number was also blamed on higher energy prices that subsequently put caution on companies’ hiring plans.

The pessimists, on the other hand, profess that the U.S. economy is on the verge of slowdown just like the rest of the world as witnessed in Europe and Asia. Inflation is believed to be on an upswing due to numerous factors being touted every

time oil prices go up or any other economic indicator that suggests the Fed is behind the curve. Economic indicators have been very spotty all year long, which makes good fodder for market players to validate their assumptions. After a 225-basis-point rate hike, interest rates are still a “conundrum” – so described because when short rates are moving up so should the long-term rates to form an upward-sloping yield curve. Low long-term rates, however, have been stuck in the high end of its range, flattening the yield curve.

Conundrum redux

One valid explanation to explain Greenspan’s “conundrum” on low long-term rates is the savings-glut theory. Ben Bernanke, a former Fed governor, explained it succinctly: low yields in most industrialized countries could prove there is a scarcity in investment opportunities that could produce returns higher than the cost of capital.

Another explanation for the interest-rate conundrum is that monetary policy is the only tool left to jump-start flailing economies. Budget deficits in Europe prevent those countries from pump-priming their respective economies, while Japan has tried that technique earlier and would definitely not go the same route. The Euro-bloc economies have already been suffering from a slowdown, especially in Germany, France and Italy, while the Japanese economy has been fighting seven years of deflation due to the absence of growth. Subsequently,

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Market summary *from page 1*

a slowdown could force central banks all over the world to pause from hiking rates or even ease rates in the near future. Monetary policy's effectiveness, however doubtful, is still being used even though long-term rates have gone south. Investors have seen that central banks can only influence the short end of the curve.

China has been the sentinel of growth in the global economy, together with other Asian economies, but slowdown there seems imminent as well. China has resisted calls for the Yuan revaluation as exports could weaken the country's economic growth. They gave their trading partners a small concession by widening the Yuan's trading band by 0.3 percent, akin to a revaluation. Despite a small step to revaluation, most of the capital surplus in Asia will find a home in the U.S. bond market, corporate assets and real estate. Asia's growth story rests on its export-driven economic model and managing currency is used as a tool to maintain growth and curb inflation.

Recycled capital through the bond market, in turn, creates a regime of low global long-term rates. Excess U.S. dollars go back to the system diminishing pressures for Asian countries to revalue local currencies. This phenomenon has benefited the US economy which supports consumer spending and the housing market, the twin engines of growth. Benefits also come in the form of reduced risk premium and inflation expectations. One could surmise that the interdependency of the global economy rests on US monetary policy. The fragile global economy depends on the US ability to balance the need for growth and tame inflation.

The interest-rate conundrum has also given rise to talk about bubbles being created by yields staying so low. If the Internet bubble was the hottest topic in the '90s, the property market has become the new "whipping

boy" for all the foibles of low mortgage rates. One needs to remember that a drop in long-maturity debt like the 10-year notes helps determine fixed-rate mortgages. The 10-year area of the yield curve has hovered around 3.9 to 4.2 percent for the past six months and fixed-mortgage rates have remained near their lows for the year.

Mortgage products have evolved from the traditional options a few years ago. The financial sector has developed a system of packaging different products depending upon the buyers' risk tolerance. There is no doubt that the corresponding risk to real estate has been perceived to be quite low, fueling a boom in the housing market sector. Clearly, excessive liquidity is a valid reason for driving up real estate and bond prices. Some bond players believe the Fed needs to hike rates to cool the real estate market.

Inflation and the U.S. economy

It is not difficult to see why investors are divided into two camps: the growth and the economic slowdown camp. There are numerous factors that could give both arguments credibility. Jobs are plentiful but manufacturing jobs are still weak. The economy has a tight labor market but productivity has slowed down and unit labor costs have gone up.

These conflicting signs lead investors to believe two diverging paths, as well. The first path is for investors to conclude that the Fed will continue raising interest rates to achieve sustainable growth and fight the ominous signs of inflation. The other view believes there is only one more rate hike before the Fed admits to a slowdown. Inflation has been hovering above trend lately, but economists argue that this could be due to higher energy prices. Producers have expressed their intention to pass on higher costs to consumers if energy prices remain at current levels. High energy prices might

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Market summary*continued*

restrain consumer spending which could contribute to a slowdown. Greenspan said in his Joint Economic Committee statement to Congress that energy prices could shave-off $\frac{3}{4}$ -percent in GDP estimates.

It is, indeed, a glass half-empty or half-full. What has inflation done for the first half of the year? Inflation has been running above 2 percent over the past five years despite higher energy prices. This year is no different, even as oil prices reached \$60 a barrel. This has allowed the U.S. economy to grow without inflation and induced a low-interest rate environment, propping up growth in consumer spending. It has also created the much-talked about “froth” in the housing market. For the Fed to depart from its “measured” pace, it needs to see either an elevated inflation rate or unmanageable growth in the economy. A more pragmatic way to look at the economy at this point is to assume that it is neither hot nor cold.

The bond market and flat yield curve

The bond market has shown tremendous resilience even after a string of nine consecutive rate hikes. This is not merely a U.S. phenomenon – low bond yields are a global phenomenon. The Fed rate hikes seem to affect only the short-end of the curve. Investors are buying up the long-end of the curve for want of a better yield and also an implicit assumption that the Fed will soon achieve a neutral rate that could signal a rate pause.

International investors have exacerbated the flattening curve due to various needs and the situation mentioned earlier. The confluence of various factors created a huge demand in the long-end of the curve, driving yields down to 4 percent in the 10-year area of the curve. The curve has been flat and seems to get flatter, creating no rolldown advantage for investors in the short-end of the yield curve. Yield-flattening trades have continued to be the default strategy of most money managers.

The front-end of the curve underperformed again as the 3- and 6-month bills have gone up by 38 and 32 basis points to 3.25 and 3.49 percent, respectively. The two-year notes registered a 27 basis point increase in yield to 3.89 percent, creating a narrow spread between the three-year notes of around 5-6 basis points on swap spread basis. The 2-year and 30-year swap spreads showed a more pronounced tightening from 70 bp during the first quarter to 58 bp, clearly the result of intense yield-curve-flattening trades.

There are seminal articles discussing the possibility of the yield curve inverting if the long-term bonds stay in their current trading range. An inverted yield curve is widely believed to be an omen for an impending recession. The very flat yield curve could invert, especially now that the spread has narrowed significantly. Greenspan has refuted this belief by saying that even a flat yield curve does not necessarily mean a precursor for a slowdown. The next FOMC meeting in August will hopefully give guidance if the “measured pace” and “neutrality” in rates is still in synch with Fed’s view about the economy.

The LGIP

In what is starting to sound like a broken record, the fed funds rate was raised by 25 bp at both the May and June FOMC meetings, bringing the rate to 3.25 percent. The Fed is widely expected to raise the rate again by 25 bp at the August 9 FOMC meeting. As has been the case for the last year, in anticipation of rising rates the average life of the LGIP portfolio has been kept around 30 days in order to be able to reprice to the rising funds rate as quickly as possible.

Accordingly, the net LGIP yield increased from 2.77 percent to 2.98 percent and then to 3.04 percent during April, May and June, respectively. LGIP participants should expect the LGIP yields to continue to rise as long as the Fed continues to raise the fed funds rate.

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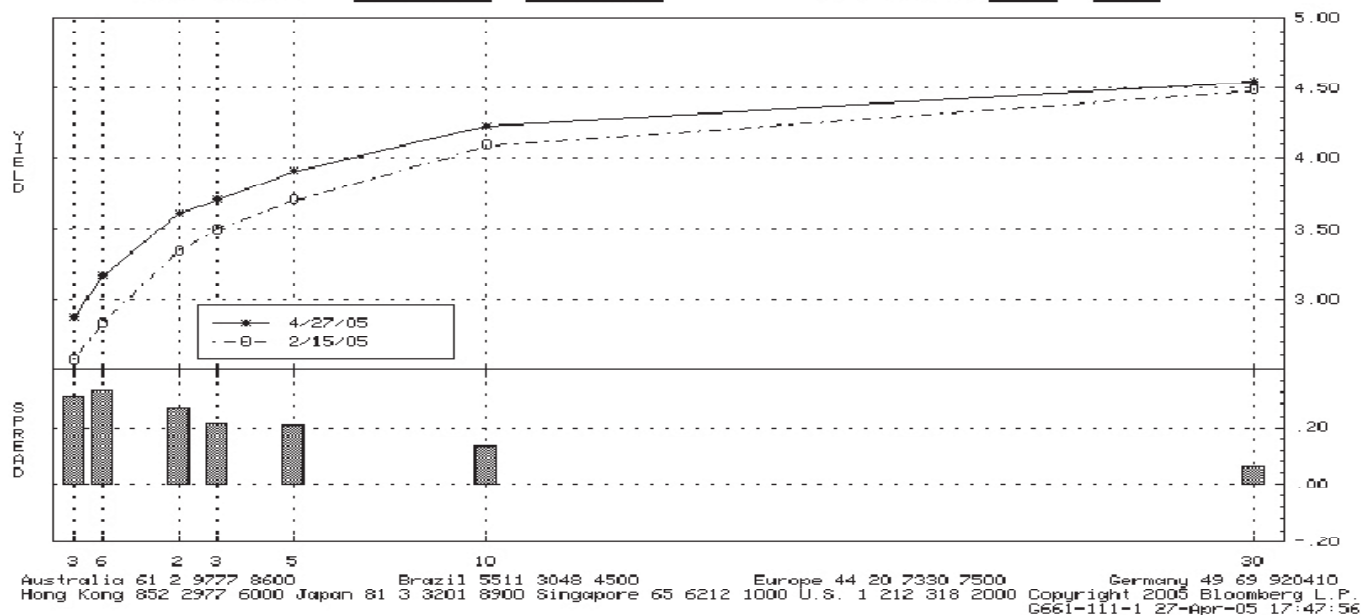
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HISTORICAL YIELD CURVE

PAGE 1 OF 2

DATE RANGE 2/15/05 4/27/05

MTY RANGE 3M 30Y



From the LGIP Administrator's Desk

By Robbi Stedman

As the old saying goes "time flies when you are having fun!" My first month as the LGIP administrator has gone by extremely fast. I have truly enjoyed my experience so far. It has been nice to get to know some of you over the phone, and for those of you that I haven't spoken with yet I will look forward to meeting you in the future. Jen is doing a great job of teaching me my new position. I am trying to be a sponge and soak up as much of her knowledge as I can before she leaves. We will miss her, but the kids will be very lucky to have her. As I have said before I feel very honored to be your LGIP Administrator and look forward to building relationships with all of you in the months to come.

LGIP Holiday Schedule for 2005-2006

The Local Government Investment Pool will be closed on the following days:

Monday	September 5	Labor Day
Monday	October 10	Columbus Day
Friday	November 11	Veteran's Day
Thurs/Fri	November 24-25	Thanksgiving Holiday
Monday	December 26	Christmas
Monday	January 2	New Year's Day
Monday	January 16	Martin Luther King, Jr. Day
Monday	February 20	President's Day
Monday	May 29	Memorial Day
Tuesday	July 4	Independence Day

Opportunity* knocks at WFOA ...

*a chance to learn from top financial experts in investments and debt

We've listened to you. Your questions and suggestions have guided the Office of the State Treasurer in bringing some of the top experts in investments and debt to this year's WFOA Conference in SeaTac — people like the managing directors of investment firms, vice presidents of municipal banks, bond counsel and financial advisors are coming from New York, San Francisco and across the state. On Wednesday, Sept. 14, you'll have the opportunity to attend their presentations and ask questions.

Speakers include:

Eric M. Bergson
VP, Portfolio Analysis Group
JP Morgan

David Boberski
Managing Director & Head
of Interest Rate Strategy
Bear Stearns & Co.

Rob Byers
Vice President
Deutsche Bank Securities

Alan Dashen
President
A. Dashen & Associates

Mary Beth Fisher
Associate Director &
Interest Rate Strategist
Bear Stearns & Co.

Michael Hieb
VP, Corporate Trust
Administration
Bank of New York

Andy Jeremi
VP, Institutional Sales &
Asset Management
Union Bank of California

Susan Musselman
President
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Jeff Nave, J.D.
Chair, Municipal Law &
Public Finance
Foster Pepper &
Shefelman, PLLC

Deanne Woodring
Managing Director & Senior
Advisor
D.A. Davidson's Portfolio
Benchmark Advisors Group

Carolyn Whalen
Vice President
US Bank

Best Practices for Portfolio Management

An advisor to fixed-income portfolio managers, **Deanne Woodring**, will show participants how to manage investment portfolios through policy, cash flow, asset allocation and strategy, along with a meaningful performance benchmark. Deanne has 23 years experience and speaks nationally on portfolio benchmarking as an essential tool in providing discipline and cost savings. This session is designed for investment officers and fiduciaries.

Evaluating Agency Callables

Agency issuance has switched from large benchmark deals to smaller medium-term-note (MTN) issues. Along with this change has come a renewed focus on one of **Mary Beth Fisher's** primary areas of research — valuation of callable agencies. This session will examine the risks and rewards of this transition, as well as the future of the MTN market.

Interest Rate Strategies

Dave Boberski will bring his extensive research experience to bear on questions such as 'What influence does the business cycle have on fixed income markets?' After teaching portfolio theory economics, Dave is now responsible for consolidated research across product lines including futures and derivatives. He will discuss some consistent response patterns in the yield curve to different business cycles and how strength or weakness along one economic variable can echo throughout the curve. The session will look at how the current cycle stacks up against history and what may lie in store for the rest of this expansion.

Investment Fundamentals

Rob Byers' focus has been mainly on shorter duration securities. He has analyzed products for 2a7 money market funds, municipalities, banks and corporations. Rob will discuss some of the fundamental concepts of investing, beginning with eligible investments. Participants will become familiar with basic investment concepts such as interest rate cycles, the yield curve, yield calculations and how to use gap analysis to evaluate short-term investment options. The inclusion of the LGIP or other liquidity vehicles in analyses will be discussed.

Making the Decision to Refund Bonds

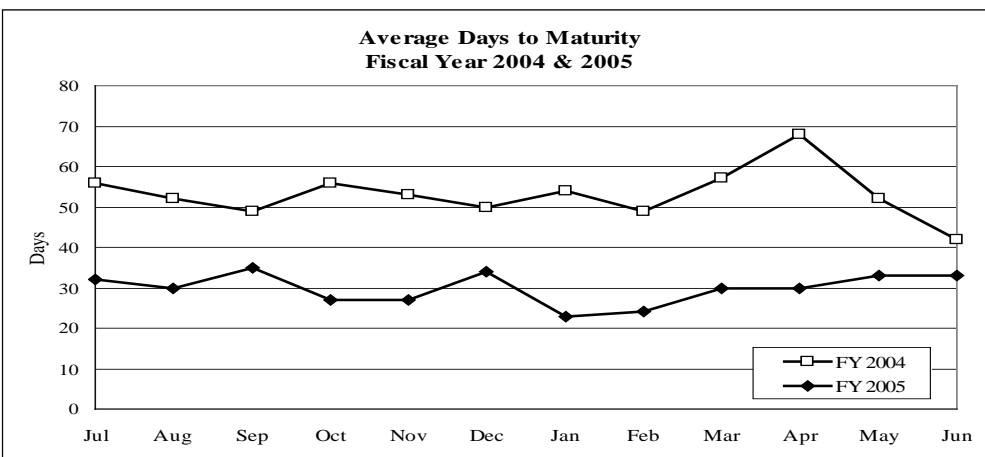
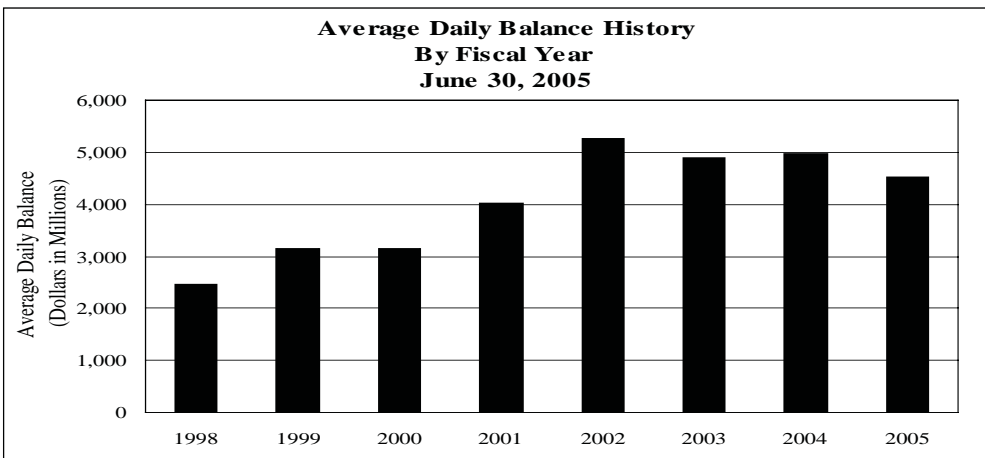
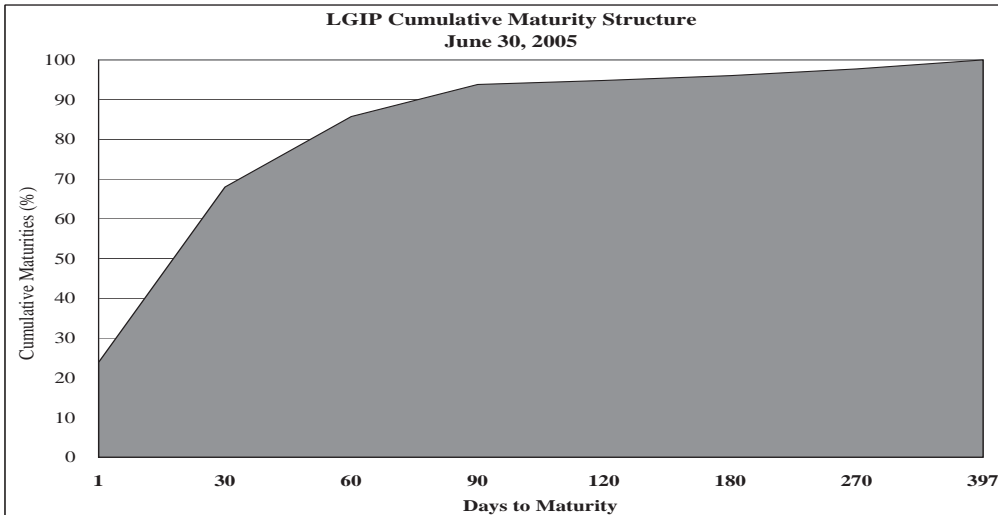
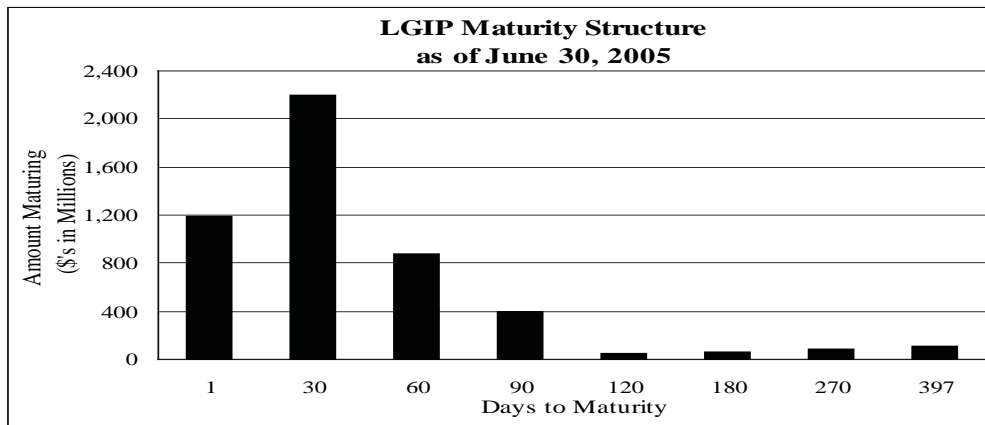
Susan Musselman and **Alan Dashen** will present the five important questions that should be asked and answered before selling refunding bonds. These two independent financial advisors who work extensively with municipalities in Washington, will discuss the market factors that drive refundings and how to determine whether time and circumstance are right for a refunding. Participants will learn the importance of setting refunding targets, how negative arbitrage can work against them and how moving down the yield curve can work to their benefit.

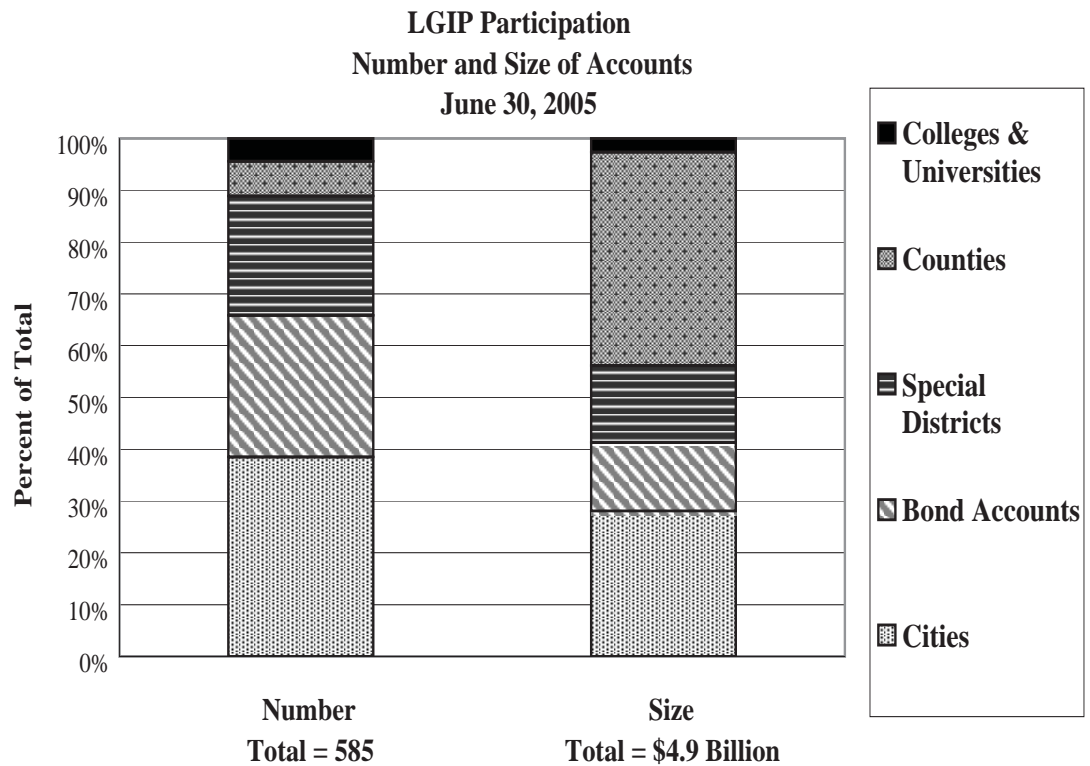
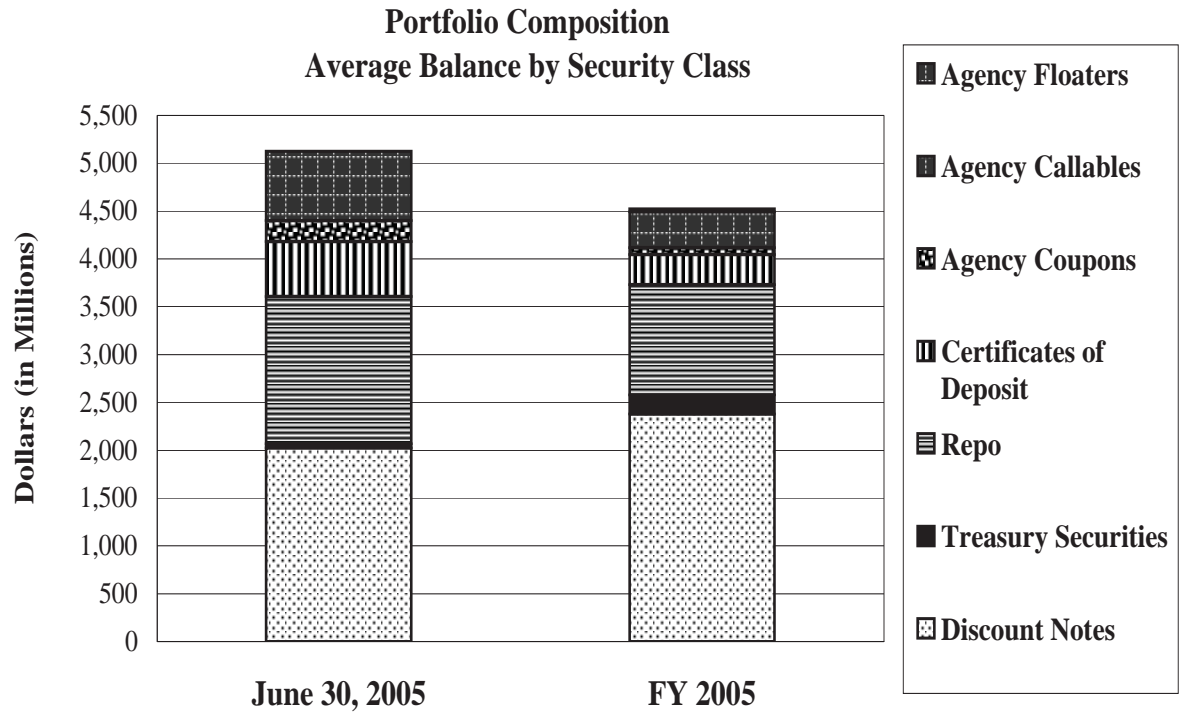
Relative Value Analysis

Asset managers who are trying to cut through 'the sweet talk' will find **Eric Bergson's** presentation on value analysis invaluable. Eric will share his knowledge of portfolio analysis and strategies, model development and relative value analysis with participants interested in increasing their portfolio's total returns. Participants will learn how to take advantage of the yield curve and how to uncover 'the catch' in esoteric securities offerings.

Trustees — Who are these guys anyway?

At some point you might be required to arrange for a trustee — an appropriate trustee. **Jeff Nave**, who heads the Foster Pepper municipal finance group, will provide an overview of the legal structure of trustee services in Washington State. This legal structure will often determine what is an 'appropriate' trustee. **Andy Jeremi**, responsible for sales of custody and corporate trust services to municipalities and the public sector, and **Carolyn Whalen**, who manages corporate trusts, will describe the trust services offered to municipalities by their banks. Finally, **Michael Hieb**, who is responsible for the daily operation of the Fiscal Agency Unit at the Bank of New York, will explain the registrar/paying agent services the bank as state Fiscal Agent provides to Washington state governmental entities.





LGIP Advisory Committee: July 29, 2005 Meeting Minutes

The LGIP Advisory Committee meeting was held Friday July 29, 2005, at noon in the Office of the State Treasurer, Legislative Building, Olympia, Washington. The following members were present: Chuck Greenough, Lisa Frazier, Mark Wyman, Dan Underwood, Tracy Shawa, Carrie Lewellen, Morgan Jacobson, Barbara Stephenson, and Shelly Pearson. Treasurer's Office staff included Assistant Treasurer Michael Colleran, Doug Extine, Jen Thun, and Robbi Stedman. The following members were absent: Treasurer Michael J. Murphy, Dani Burton, Lynn Hills, and Stan Finkelstein.

Doug Extine welcomed three new members to the LGIP Advisory Committee. Treasurer Murphy appointed Carrie Lewellen, Treasurer, City of Vancouver; and Morgan Jacobson, Treasurer, City of Tacoma. Tracy Shawa, Pacific County Treasurer, was appointed by the Washington State Association of County Treasurers. These appointments are all for three-year terms which will expire on April 30, 2008.

Doug announced staffing changes for the Investment Team. Mary Pheasant left the Treasurer's Office in June to pursue the role of a Confidential Secretary at the Washington State Patrol. Doug welcomed Robbi Stedman who was hired as the new LGIP Administrator as of July 1. Though new to the LGIP, Robbi has worked at the Office of the State Treasurer since September 2004. Jen Thun will be leaving the Office of the State Treasurer at the end of August. Doug announced the creation of a new position in the Investment Office, the Portfolio Administrator. The Portfolio Administrator will take the duties of the Operations Officer, which Jen has been performing, as well as other portfolio related duties. This will allow Robbi to focus solely on LGIP Administration and allow Doug to continue managing the LGIP Portfolio on a full-time basis. The office is currently in the process of hiring the Portfolio Administrator.

Doug gave an update on the performance of the LGIP. The net rates for the Pool for April, May and June were 2.7703, 2.9758, and 3.0411 percent, respectively. The fed funds rate has gone up 25 basis points (bp) at each FOMC meeting, i.e., 3.00 percent on May 3 and 3.25 at the June 30 meeting. The next meeting is scheduled for August 9 and it is anticipated there will be another 25 bp increase.

Doug spoke about the strategy for managing the LGIP portfolio. Currently, the portfolio has an average life of 30-33 days. As has been the case for the past several months, the strategy is to keep short in anticipation of continued fed fund increases. A handout was distributed with graphs comparing historical LGIP rates with iMoneyNet (the LGIP Benchmark) and the Targeted Federal Funds rates. Discussion followed.

Jen distributed a handout to committee members describing LGIP month-end balance activity and daily balance activity for FY 2004 through FY 2006. The balance in the Pool is currently at \$4.6 billion.

Jen reviewed the Fiscal Year (FY) 2005 budget utilizing a handout showing the budget estimates for FY 2005. The estimate of fees and overdraft charges of \$1,607,839 is slightly higher than the original estimate of \$1,404,000, and the expenses of \$537,429 are lower than the original estimate of \$579,000. The estimated rebate for FY 2005 is now \$1,070,410 which exceeds the original estimate of \$825,000 by \$245,410. The rebate will be finalized on August 1.

Robbi discussed the cause of TM\$ being disabled on Tuesday, July 26. An overnight processing error occurred which prompted IT staff to shut down TM\$ temporarily so they could correct the error. TM\$ was fully operational later that same morning.

Jen discussed a Post Implementation Review of TM\$ that is being organized by OST IT staff. The Client Survey will be distributed in late August to OST staff, state agencies, revenue distribution clients, and LGIP clients who utilize TM\$. The survey is being conducted to evaluate the success of TM\$, the value added by TM\$, and what can be done to improve TM\$.

Doug discussed the upcoming LGIP external audit which will be performed by Peterson Sullivan for the fourth year. A preliminary meeting was held with OST Investment and Accounting staff and Peterson Sullivan on July 28. Peterson Sullivan plans to conduct their field work in late August.

A discussion was held regarding the time limits and transaction size limits for LGIP withdrawals and deposits. A participant had asked if the Advisory Committee would examine possible extensions of either the size or time limitations. Currently, transactions over \$1 million are to be requested by 9:00 a.m. and the final cut-off for same day transactions is 10:00 a.m. Doug explained that because of funding limitations, broker flexibility becomes more limited after 12:00 pm Eastern Time. That, plus the time limitations for ensuring proper trade settlement, makes it difficult to extend the time deadline past 10:00 a.m. Discussion followed. The advisory committee agreed that the current size and time limitations were agreeable.

Doug discussed the upcoming Statewide Custody search. The current contract will expire in 2006 and a RFP process will be used to select a statewide custody provider. This process will begin in October. Advisory members were encouraged to participate in the search. Discussion followed.

The next meeting will be October 21, 2005.

The meeting was adjourned at 2:00 p.m.

Washington State Local Government Investment Pool
Position and Compliance Report
as of 06/30/2005
(Settlement Date Basis)

(In Thousands)

LGIP Portfolio Holdings

	Amortized Cost	Percentage of Portfolio
Agency Bullets	\$ 202,674	4.09%
Agency Discount Notes	1,834,511	37.00%
Agency Floating Rate Notes	732,073	14.76%
Certificate of Deposit	143,250	2.89%
Interest Bearing Bank Deposits	429,234	8.66%
Repurchase Agreements	1,566,853	31.60%
U.S. Treasury Bills	24,815	0.50%
U.S. Treasury Coupons	24,951	0.50%
	<u>\$ 4,958,361</u>	<u>100.00%</u>

Securities Lending Holdings

Repurchase Agreements	\$ 80,899
	<u>\$ 80,899</u>

**Total Investments &
Certificates of Deposit**

	<u>\$ 5,039,260</u>
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Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

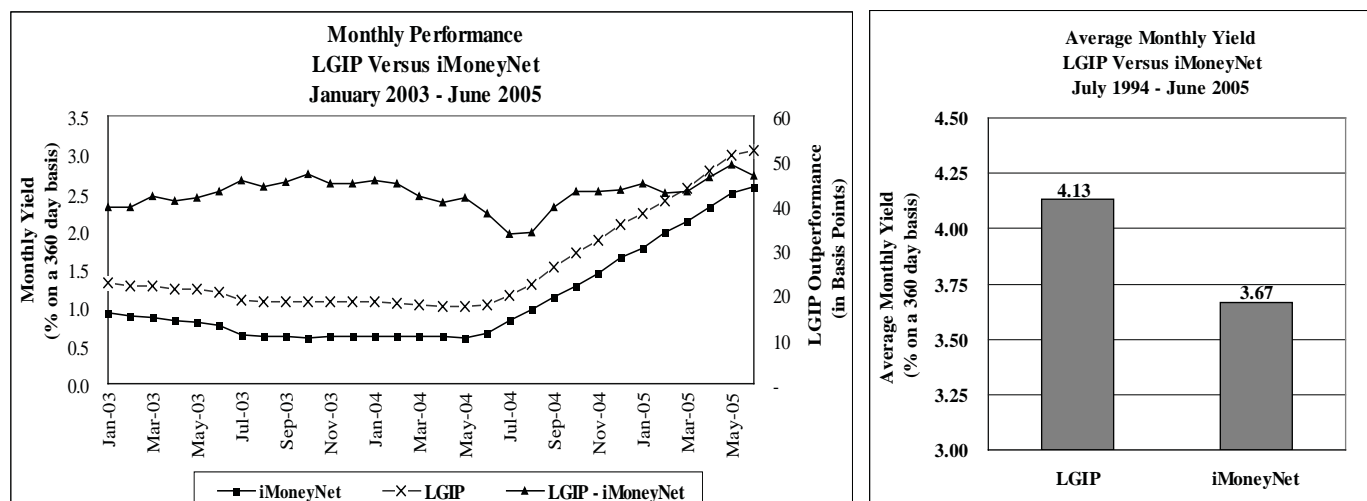
	Holdings	Percentage of Portfolio	Policy Limitations Percentage
Floating Rate and Variable Rate Notes	\$ 732,073	14.76%	30%
Variable Rate Notes > 397 Days	100,000	2.02	10%
Other Structured Notes	0	0.00	10%
Term Repo > 30 Days	0	0.00	30%
Certificate of Deposit	143,250	2.89	10%
Bankers' Acceptances	0	0.00	20%
Commercial Paper	0	0.00	25%
Reverse Repo	0	0.00	30%
Security Lending + Reverse Repo	79,690	1.61	30%

Maturity Limitations

	Currently	Policy Limitations
Weighted Average Maturity	33 day(s)	90 day(s)
Maximum Maturity		
Bullet Maturities	350day(s)	397 day(s)
Floating Rate and Variable Rate Notes	456day(s)	762 day(s)
Repos	27 day(s)	180 day(s)
Reverse Repos	0 day(s)	90 day(s)

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LGIP Performance Comparison iMoneyNet, Inc.¹ versus Local Government Investment Pool



The chart on the left shows a monthly comparison from January 2003 through June 2005 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to June 2005. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.4 basis points. This translates into the LGIP earning \$176.14 million over what the average comparable private money fund would have generated.

¹ Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, *Money Market Insight*, iMoneyNet, Inc., West borough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Position and Compliance Report as of 6/30/05 from page 9

Repo Limits Per Dealer

	June 30, 2005	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 7/1/2005	Projected Position 7/1/2005
Banc America Securities	\$ 260,000	5.24%	0.00%	\$ 260,000	\$ 0
Bear Stearns & Co.	400,000	8.07%	4.03%	200,000	200,000
Goldman Sachs	67,430	1.36%	0.00%	67,430	0
Lehman Brothers Inc.	306,853	6.19%	0.00%	306,853	0
Merrill Lynch	200,000	4.03%	4.03%	0	200,000
Morgan Stanley Dean Witt	413,468	8.34%	8.07%	13,468	400,000
Total	\$ 1,647,751			\$ 847,751	\$ 800,000

Local Government Investment Pool
STATEMENT OF NET ASSETS
June 30, 2005

(In Thousands)

Assets

Investments, at Amortized Cost:	
Repurchase Agreements	\$ 1,566,853
U.S. Agency Securities	2,769,258
U.S. Treasury Securities	<u>49,766</u>
Total Excluding Securities Lending	\$ 4,385,877

Securities Lending Investments, at amortized cost:	
Repurchase Agreements	<u>80,899</u>
Total Investments (Settlement Date Basis)	\$ 4,466,776

Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:	
U.S. Agency Securities	\$ <u>43,661</u>
Total Investments (Trade Date Basis)	\$ 4,510,437

Interest Bearing Bank Deposits	\$ 429,234
Certificates of Deposit	143,250
Cash	1
Interest Receivable	<u>9,086</u>
Total Other Assets	\$ 581,571
Total Assets	\$ 5,092,008

Liabilities

Accrued Expenses	\$ 153
Obligations under Securities Lending Agreement	80,899
Investment Trades Pending Payable	<u>43,903</u>
Total Liabilities	\$ 124,955

Net Assets	\$ 4,967,053
Total Amortized Cost - Settlement Date Basis	\$ 5,039,260

QUARTER AT A GLANCE
April 1, 2005 to June 30, 2005
(In Thousands)

Total investment purchases:	\$ 41,598,686
Total investment sales:	\$ 1,870,900
Total investment maturities:	\$ 39,268,885
Total net income:	\$ 38,037
Net of realized gains and losses:	\$ 6
Net Portfolio yield (360-day basis):	
	April 2.7703%
	May 2.9758%
	June 3.0411%
Average weighted days to maturity:	33 days

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